CANADA-UKRAINE
REGIONAL GOVERNANCE AND
DEVELOPMENT PROJECT

КАНАДА-УКРАЇНА
ПРОЕКТ «РЕГІОНАЛЬНЕ
ВРЯДУВАННЯ ТА РОЗВИТОК»

Regional financial instruments and fiscal decentralization, regarding the local taxation and regional credit market

Izabella Barati-Stec, Phd[1]

A presentation prepared for the "Research Mission" in Hungary for Ukrainian experts organized by CUI/CIDA

June, 2006

---

[1] Izabella Barati-Stec, PhD is an adjunct professor at Budapest Corvinus University.

Among municipal systems, we can differentiate between Nordic and southern type systems. The Nordic type describes bigger municipalities with more responsibilities, while the southern type describes smaller municipalities with fewer responsibilities. The Hungarian system does not fit either category, as according to the municipality size it is closer to the southern, but according to the municipal responsibilities, it is closer to the Nordic type system.

One way of measuring the decentralisation of a country is to look at what level is responsible for what kind of services.

According to Musgrave (1984) there are three main types of public services -- allocation, redistribution and stabilisation -- the latter two of which are better kept at the central level.

Municipal systems with small autonomous municipalities face the specific problem of the transboundary effects of services. This problem exists in Hungary. It means that the effect of a public service in one municipality may be a negative or positive externality for another settlement, which did not ask for the effect, did not pay for it, or was not compensated for the harm caused by it.

These are called spillover effects. In order to minimise these effects, services should be delegated to the lowest level that is able to manage it, and where most affected people can express their wishes. (Huther- Shah [1998] pp. 10., Shah [1994].) This is also expressed by the subsidiarity principle.

There are three forms of dividing tasks between the levels of government.

- Pure separation means the lower level fulfils its responsibilities independently from the higher ones, and has discretional decision-making rights that the state has no control over.
- Shared responsibility is when the upper and lower tiers co-operate when carrying out certain tasks.
- Official relationship is when the lower tier is obliged to carry out programs supervised and designed by the upper tiers.

In Hungary, the responsibility for most functions is shared among the governmental tiers, and when delegating tasks to the lower levels, the subsidiarity principal is taken into account.

As a consequence, the county is only responsible for tasks that satisfy the needs of more than one settlement, but at the same time, if a settlement is able to provide the service, it can take it over from the county.

The potential hazard of this practice is that the county is often left with the most expensive tasks to carry out, such as maintaining hospitals. In the light of the fact that the revenue raising capacity of the county is limited, this problem requires special attention from the central government.

Financial sources for fulfilling responsibilities

When decisions are made about financial questions - such as which governmental

level collects what kinds of revenues, which ones of them will be earmarked and which ones will not, to what level they will be redistributed, etc. -- the efficiency of the system is also determined.

It is generally true that the higher the local income (fees and taxes) in the municipal budget, the more responsibilities are delegated to the local level, and vice versa.

The Hungarian system on this point is controversial, because a wide range of services is delegated to the local level with a relatively low income.

The Hungarian Constitution and the Act on local governments also contain provisions on the financial resources that the state should provide when delegating a service to the local level. As the two laws do not use the same wording, it is possible to use each of them to support certain arguments. According to the Constitution, the state should provide the “necessary” funding, while according to the Act on local governments, the state should provide the “sufficient” financial sources with the delegated service.

In my understanding, the state should provide the possibility and capacity for the municipality to raise local revenues for a specific service, e.g., through taxes and fees, but should not guarantee the revenue itself. So the state does not have to finance a local service up to 100%, but has to enable the municipality to raise funds for it. This is in accordance with the European Charter on Local Self-Government[2], and this is the rule in most developed countries.

---

[2] The Charter on Local Self Government was accepted in 1985 by the Council of Europe.Since then, many European countries have accepted it as guidance for their municipal acts.

Public finance literature agrees on two reasons for increasing the proportion of the municipal budget raised through its own revenue. One is the “fiscal”, the other is the “accountability” argument. (Bahl, [2000]).

I. The first reasons that central governments facing tight budget constraints, in order to solve their own deficit problems, will decrease the amount of transfers to the local level. The decrease in the transfers increases the local deficit, which can be solved by raising local income. If a municipality has local revenue sources, it is less vulnerable against changes in the central transfer policy. A typical action of a government that faces a deficit is to decrease transfers, rather than to take over the collection of local taxes. Moreover, where there are shared taxes, the state is likely to increase those taxes that it does not have to share with the local level.

II. The accountancy argument refers to the transparency of the way the budget is spent. Local investments are financed from taxes that constituents pay directly or indirectly into the local budget. If constituents pay the money into the central budget, its route is difficult to follow, but if they pay it into the local budget, the local representatives are directly accountable. The higher the share of money paid into the local budget, the more power the taxpayer wants to exercise over local decision making.

The following can be added as a third argument:

When a municipality increases its local revenues, it also raises its fiscal capacities, as it will possess discretional revenue and will become independent from central decisions. This has a positive effect on the municipality’s credit rating, making other revenue sources, such as loans, available.

The parameters for evaluating the local tax system

When designing a local tax system, several questions must be answered to help in choosing among the possibilities, e. g., how broad the discretion of the settlements should be, what the historical background for implementing a special tax is, etc.

There are five parameters based on which we can compare, and choose among, local taxes[3].

1) Efficiency.

   An efficient tax will have no effect on economic decisions. A tax cannot be 100 % efficient, but the goal should be that the tax will have the least possible distortion on the price of the services and goods, and will have the least possible impact on the amount consumed.[4]

2) Fairness.

   One can speak about horizontal or vertical equalisation. The first means that people in the same situation pay the same tax. Vertical equity is very difficult to achieve. This latter means that the better-off are taxed more heavily than the worse-off. This can be reached by very complicated redistributive, equalisation systems.

---

[3] Davey – Péteri, [1998], Ebel – Várfalvi – Varga, [1998], Boadway – Kitchen [1999], Tassonyi – Szalai [2001] give a good overview of the issues of taxation.

[4] Rational consumer consumes less if prices go up.

3) The cost of tax administration.

This cost should not be higher than the benefit deriving from its collection. Each tax imposes extra costs on their payers by the necessary audits, accounting, record-keeping, billing, collection, enforcement, etc.) These costs should be minimised.

4) The possibility of tax competition.

When a tax is levied on a mobile base, taxpayers will have an incentive to move to a settlement with a lower tax rate. This is a “catch 22”, because the municipality is left without a tax base, and the municipality that attracted the taxpayer with the lower rate will not be able to raise taxes because it would lose its attractiveness. This process will go on until the average tax rate is so low that it is not even efficient to collect it. (The administration costs will be high compared to the benefits.)

5) The possibility of exporting the tax.

When a municipality has the possibility of taxing non-residents, it will do so. This happens when a municipality taxes those activities that are able to pass the tax to consumers from other jurisdictions.

Fees for services

Unlike user fees, taxes are mandatory levies that are not directly linked to specific services. Rather, they serve redistributive purposes.

User fees are linked to specific services, and they can be narrowly defined as charges levied on consumers of goods and services. Public finance literature suggests that they should be used as broadly as possible, although their use has some practical constraints. (Barati – Szalai [1999]).

1.) They are rarely efficient.

Efficiency means that they are equal to the real marginal cost, which is extremely difficult to define. The opportunity cost[5] and the social cost of an activity should be considered when deciding the charge levied on consumers.

2.) *Positive side effects.*

When an activity has positive side effects (positive externality), local governments like to subsidise this activity in order to encourage it.

3.) Non-excludable public services.

There are many non-excludable public services, that is, those that the non-payers cannot be excluded from the use of. In these cases, financing from

[5] Opportunity cost: The lost benefit of project B that occurs when we prefer project A to project B.

taxes is more adequate than financing from fees.

The dilemma of financing from loans or a municipality's own sources

When a municipality starts an investment, it has to face the question whether to borrow or to finance from the currently available sources in the budget

Arguments for loan financing

In general, in growing economies, loan financing proves to be a better option (Petersen [1999.]). The reasons are as follows:

- Current revenues are insufficient and too inflexible to fund "lumpy" cash needs on a pay-as-you-go basis. Projects need pre-financing from the beginning, when it does not yield any revenues.
- Future inflation reduces the cost of borrowing. Debt can be repaid with currency that is worth less than the value of that borrowed.
- The investments financed from loans are revenue generating, and based on economic reasons, it is better to divide the expenses during the life of the asset, and not to put such a burden on the municipality at the time of purchasing. This is also considered to be a "fair" division of expenses among the users of the asset.[6] Payment of costs for use of capital can be synchronised with the flow of benefits over the useful life of the asset being financed.

---

[6] The contrary of this theory also can be found in the literature, e. g., we do not know what the future generations will need, and by a decision today we will reduce their possibilities and their financial resources.

- These investments are usually needed for sustaining growth. Without them growth would slow down.

Arguments against loan financing

Of course, the conservative approach, “pay as you go” financing, also has its own advantages. Some of these are:

- No interest expense is incurred. Money not spent on interest costs can be used to fund additional projects. Municipalities raising loans spend the money of future generations, and decrease the municipality’s freedom of decision.
- Debt capacity is reserved for other, possibly more important future projects.
- Future users/taxpayers are not responsible for paying for projects approved by today’s government.
- The use of credit is too tempting and will lead to over-commitment of future resources.

The prerequisites of municipal creditworthiness at the local level

Local governments are considered creditworthy when they meet the following requirements:

1.) a stable revenue

2.) good management skills and an efficient decision making system

3.) local politicians who are able to make decisions

4.) local citizens who are creditworthy as well, and are supporting their politicians

5.) good cash-management, an efficient tax-collection system, and effective actions against non-payers

6.) trust of the lenders (public opinion) in the specific municipality.

The central government has two main tasks related to the creditworthiness of municipalities. First, it has to keep its own creditworthiness as high as possible in order to maintain the creditworthiness of the municipalities and secondly, it has to create the institutional and legal background for municipal credit market participation.

Even in countries where municipalities are free to participate in credit market transactions, the central government might set limits for municipal borrowing. This is needed because the market often assumes the existence of central guarantees of local debt, even where not explicit, which might seriously undermine the creditworthiness of the state. Other reasons for central intervention are: (i) local borrowing raises the cost of capital for the private sector; (ii) the state might compete for the same resources as the municipalities; and (iii) it worsens the balance of the central budget.

On the other hand, to some extent the state might support municipal borrowing. The reasons are:

(i) Local borrowing decreases the financial burden on the central budget.

(ii) Loans are usually more efficient than grants (the efficiency of capital increases).

(iii) Municipalities realise improvements from loans that are closer to the needs of citizens as compared to grants.

(iv) The repayment of the debt can last the whole lifetime of the realised asset.

(v) Local borrowing provides a good investment opportunity for the local financial market, pension funds and insurance funds.

Tools for enhancing municipal credit market participation

The simplest form of enhancing municipal credit market participation is to offer state guarantees on municipal loans.

A state guarantee occurs when the state, instead of subsidising an investment directly, guarantees the loans raised for the investment. These guarantees can be direct, as in the practice in most Central and Eastern European countries, but in most cases they are indirect, i. e. the project for which the loan is needed must be approved by a state agency in order for the municipality to be able to raise the loan.

In the case of indirect guarantees, lenders assume that the state, after approving a project and the raising of the loan, also guarantees the necessary loans. This involves the risk of “moral hazard”, meaning the situation where municipalities, because they can easily get access to loans, will borrow much over the limits, and the state will be responsible for repayment. If this happens, it has a negative effect on future borrowing conditions, as lenders in such circumstances will ask for even greater insurance (Darche [1997]).

The most common form of direct guarantee is the guarantee of loan repayment, but guarantees can take other forms too, such as guaranteeing the exchange rate or a certain level of income.

Another tool for enhancing municipal loan raising activity is the establishment of special banks, financial institutions that represent the borrowing needs of more that one municipality, therefore decreasing the costs of borrowing. Various funds that subsidise infrastructure development, and credit rating agencies that rate municipalities and municipal projects are also institutions with the purpose of helping municipalities in their credit raising activities.

Added after the presentation:

The Different Debt Types Classified According to Their Backing

In order to project the future trends in the development of the Hungarian municipal credit market, I introduce some loan constructions that are widespread in the countries with highly developed credit markets.

General Obligation Bonds (GO Bonds)

GO bonds are issued by municipalities. The backing of this type of bond consists of general revenues of the municipality, e. g. local taxes, service fees, state subsidies, and the tax- and fee-raising potential of the municipality, although it may be difficult to raise future revenues. Of course, issuing revenue bonds is only possible if the municipality has income, and/or central revenues are predictable.

In developed countries there are special districts that can issue general obligation bonds because they have a basis for backing these loans through their tax levying authority [7]. Investments that serve the needs of more than one municipality, .i .e. of a district, are financed from taxes levied by the district.

As municipal associations cannot levy taxes in Hungary, the backing of such a loan could consist of a dedicated revenue stream or other income of the partner municipalities.

In some countries, if the borrower is not able to meet its obligations, the lender may force it to raise the level of taxes. This is of course only possible in countries where the maximum level of municipal taxes is not limited by law. In such cases, the concept of GO bonds can be used in only a limited way, or its use requires other guarantees (Peterson [1998] pp 20.).

Special Purpose District

…Special Purpose Districts are political subdivisions created to provide economic development or related services to residential, commercial or industrial areas. These can be both within an incorporated municipality or outside its limits, in "developing areas". These districts can represent viable arrangements for effective delivery of public utility services such as water, sewers, hospitals, fire protection and roads, when demand overflows the administrative boundaries of individual local governments. Special district obligations are generally tax-backed although the ability of special districts to raise taxes may often be restricted, by tax ceilings for instance. "Tax Increment Districts" can be established for local governments to levy taxes on the growth of

[7] An example is the „Special Purpose District" in the USA.

property value, and these have been used to fund the re-development of neglected downtown areas. They have been viewed as viable and safe instruments when a project area is of a significant size and represents a diverse taxpayer base. Some special districts may be speculative in nature. (El Daher, [1997]) pp. 5.)

Dedicated Revenue Bonds

Municipalities undertaking specific municipal projects may issue Revenue bonds. In this case the municipality raises funds against specific (named) revenue flows . Usually the subject revenue flow is the revenue generated by the service that is financed from the loan, but it also could consist of state transfers or subsidies if they periodically and foreseeably arrive to the municipality's account.

However, this financing method, despite its positive side, has some disadvantages as well.

The positive effects are, for example, that it permits a relationship between the service and the fee for it, and if in the past the service was "overpriced" and produced extra income, the extra burden on the consumers becomes obvious.

The disadvantages are supported by economic theories. The limited reliability may hinder redistribution of infrastructure and services among population groups (say, from rich sections to poor ones) by keeping potentially redistributable revenues for the benefit of an already privileged area. The disadvantage concerns the effect on prior loans. The expressions "asset stripping" or "security dilution" concern the situation when prior lenders have looked to overall revenues as a source of repayment, and a subsequent sequestering or stripping away of revenue streams weakens the credit.

Double-barrelled bonds

Double-barrelled loans are secured both ways. They are a mixture of GO bonds and Revenue bonds. A first guaranty consists of specific revenues of the municipality or of the project, and if that is insufficient, the second guaranty consists of the general revenues of the municipality[8].

Project financing

In this case, the guaranty for the repayment of the loan is the revenue generated by the particular project and the assets of the project. The issuer is the municipality or its project. A big advantage of this form is that small municipalities with lower tax and fee income also can start bigger investments, because the rating applies to the project itself instead of the municipality (except where the law provides that the debts of a project unable to repay a loan automatically becomes a debt of the municipality, as in Canada).

---

[8] In Canada, if a municipal project fails to repay the debt, the municipality has to repay it. This means that in practice every municipal loan is a "double barreled loan".